Topics for today's investors
Fall 2019

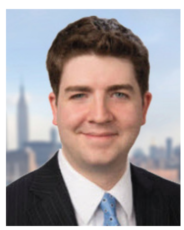
Outlook

As published by CIO Global Wealth Management (CIO)

The Murphy Wealth Management Group

David P. Murphy
Senior Vice President–Wealth Management
Portfolio Manager, PMP
Wealth Advisor
1251 Ave. of the Americas, 2nd Floor
New York, NY 10020
212-626-8895
800-458-1764
855-270-9454 Fax
david.p.murphy@ubs.com
ubs.com/fa/davidpmurphy

What is the right amount of risk?



Justin Waring
Investment Strategist Americas

It's simplistic to say we have a single "risk tolerance." We are each buffeted by at least three competing impulses: **the worrier**, who frets over making sure that the bills are paid on time; **the adventurer**, who is excited to seek out the best opportunities and willing to take risk in order to achieve great things; and **the actuary**, who is committed to making sure that we're able to retire on time and meet our goals.

In addition, no investor has a single time horizon. We each have a unique and changing mix of short-, medium- and long-term goals. Our circumstances are also dynamic, with evolving financial goals and changing resources over time.

We can't ignore behavioral risks. After all, investors won't be able to reap a strategy's full benefits if they can't stick with it during difficult periods. But we also can't let our risk tolerance have veto power. After all, these impulses are cyclical, not static, and our instincts kick in at precisely the wrong times. If we let our inner worrier define how much risk we can take, we'll be forced to subsist on the meager returns offered by the investment strategy that we can live with on our most fearful day!

In searching for the "right" amount of risk, we need an approach that accounts for human nature, rather than trying to change it. We choose to focus first on maximizing the likelihood of meeting our lifetime goals, while making sure that we can pay our bills without worrying about

portfolio depletion. But we also want to accomplish our goals efficiently, so that we can devote as much wealth as possible for the benefit of others. There's no all-in-one portfolio that can accomplish all of these aspirations without compromise, so we recommend a modular approach that can evolve with our changing circumstances.

Our solution to these challenges is to segment wealth by purpose, using the Liquidity. Longevity. Legacy. (3L)* framework, to devote and optimize resources to meet our disparate goals:

The **Liquidity** strategy is designed to meet the next three to five years of cash flow needs. Segmenting these resources helps us determine "How much cash is too much?", keeping our inner worrier at bay by insulating enough capital to pay our bills regardless of market conditions, while also curbing cash drag, which could compromise our ability to meet medium- and long-term objectives.

The **Longevity** strategy earmarks assets needed to meet all of our spending for the rest of our lifetime. This strategy gives our inner actuary a chance to shine, because these resources need to be sufficient to meet our spending needs, while accepting that we can't do so with utter certainty without incurring a great opportunity cost in the form of forgone gains. In this strategy, spending flexibility is a powerful tool.

The **Legacy** strategy represents assets that can be dedicated to improving the lives of others beyond our own lifetime. For these assets, we can indulge our "adventurer" by redefining risk and focusing on a unique goal: to grow as much wealth as possible to be transferred to future generations and charities. In this context, we are able to harness investment opportunities that might, in other contexts, incur too much "sequence of returns" risk, such as a very high allocation to public and private equity markets.

Using the methodology in our recent report, Should you reduce risk?, this 3L framework helps us choose the right amount of risk by distilling the decision into a fundamental choice between **spending flexibility** and the **expected wealth** that we can build.

* Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Gains despite the pain—3Q in review

Mark Haefele
Global Chief Investment Officer

The third quarter, which ended recently, was dominated by two competing forces. On the one hand, stocks were capped by concerns over strained US-China trade relations and deteriorating economic fundamentals. On the other, central bank easing led by the US Federal Reserve and European Central Bank (ECB) helped put a floor under markets.

While most major equity indexes, including the MSCI All Country World, were roughly flat on the quarter, the past three months have been notable for swings in bond markets. Overall, bond yields ended the quarter significantly lower, delivering strong returns to fixed income investors, especially those in longer duration bonds. The yield on the 10-year US Treasury fell around 30 basis points (bps) to 1.68%, while the same tenor in Germany fell around 25 bps to -0.56%. In aggregate nearly USD 15trn of bonds worldwide now have negative yields, and this has contributed to increased interest in gold, which rose around 5.4% in the quarter. Volatility in fixed income also led to marked sectoral swings, with a sharp reversal of the recent investor preference for defensive sectors, such as healthcare and consumer staples, over cyclical stocks such as banks and industrials.

So what is the outlook for investors for the final quarter of the year and beyond?

- **First, we expect continued uncertainty over trade to limit the upside for stocks, at least in the short term.** The eventual outcome of trade negotiations will be key for investors; a further escalation beyond the tariff increases already in the pipeline would markedly increase the risk of recession, while a lasting solution would enhance the potency of recent central bank easing. Additional tariffs are due to be implemented on 15 October and senior Chinese officials may travel to Washington in the days before then for negotiations.

  Our base case is that trade tensions will remain elevated, with the tariff increases that have already been announced being fully implemented. But we don't rule out a worsening of the situation over the next six to 12 months. Against this unpredictable backdrop, we expect stocks to remain range-bound, and we hold a modest underweight to equities.

- **Second, investors should seek equity markets and sectors that can outperform amid uncertainty.** In terms of markets, we prefer US over Eurozone stocks. The US market is less exposed to a manufacturing slowdown than the Eurozone market, which has a heavier weighting to industrials. In addition, with Fed funds at 2%, US policymakers have more scope to support growth than the ECB, where the policy rate is -0.5%. Within international equities, we also prefer Japanese stocks to Eurozone stocks. The latter have returned 21% this year, and while Japanese stocks have recently rallied, they have returned just 11%. Both the Eurozone and Japan are heavily geared to the global economic cycle, but the former has priced in a macro recovery, while the latter has not.

- **Third and finally, income-generating strategies are likely to benefit from central bank efforts to support growth.** The Fed cut rates twice in 3Q, while the ECB reduced rates and is to resume bond purchases. Markets are now pricing in negative ECB rates for more than a decade to come. But while risk-free yields are low or negative, we see opportunities for investors in US dollar-denominated emerging market sovereign bonds and in Treasury Inflation-Protected Securities (TIPS), which can benefit from easier monetary policy.

As published in the UBS House View Weekly Global, *September 30, 2019.*

Preferred investment views

This is a visual summary of our preferences. For the full detailed asset allocations see our full detailed asset allocation tables report. This table reflects positioning changes made in our intramonth report: *UBS House View update: Lowering risk in portfolios on rising trade tensions*, published on 26 August 2019.

	underweight	neutral	overweight
Total equities	⊖		
Global		⊜	
US all-cap		⊜	
US large-cap growth		⊜	
US large-cap value		⊜	
US mid-cap		⊜	
US small-cap		⊜	
Int'l developed market	⊖		
Japanese		⊜	
Emerging market	⊖		
Total bonds			⊕
US government	⊖		
US Treasuries (long)		⊜	
US TIPS			⊕
US municipal		⊜	
US investment-grade corporate		⊜	
US high-yield		⊜	
Int'l developed market		⊜	
Emerging market		⊜	
EM hard-currency			⊕
Cash		⊜	

⊕ **Overweight**
Tactical recommendation to hold more of the asset class than specified in the moderate risk strategic asset allocation.

⊖ **Underweight**
Tactical recommendation to hold less of the asset class than specified in the moderate risk strategic asset allocation.

⊜ **Neutral**
Tactical recommendation to hold the asset class in line with its weight in the moderate risk strategic asset allocation.

⊕ ⟶ ⊕ **Month-to-month change**

Please see the monthly *UBS House View: Investment Strategy Guide* for our latest views.